TEACHERS’ RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Section 415 Replacement Benefit Program	ITEM NUMBER: 9
	ATTACHMENT(S): 0
ACTION: X	MEETING DATE: April 8,1999
INFORMATION: ___	PRESENTER: Ms. DuCray-Morrill

SUMMARY

Federal tax laws provide favorable tax treatment to a “qualified” retirement plan to encourage employers to provide retirement benefits to their employees. The favorable treatment permits the California State Teachers’ Retirement System (CalSTRS) members and participants to defer paying income tax on contributions to the plan, and on the benefits accrued under the plan, until actually received. Taxes on the earnings of the Teachers’ Retirement Fund (TRF) are also deferred until paid to the member, participant or beneficiary as part of the plan benefit.

As a condition of qualifying the State Teachers’ Retirement Plan (STRP) for the special tax treatment, the Internal Revenue Code (IRC) imposes restrictions on certain aspects of the plan. The major restrictions imposed on the STRP are that: (1) a benefit must not be calculated on compensation that exceeds $160,000 and (2) a benefit associated with employer contributions and member contributions paid on a pre-tax basis must not exceed the dollar limit applicable to the age at which the member retires. The Internal Revenue Service (IRS) adjusts both the compensation limit and the dollar limits from time to time to reflect changes in the cost of living. In addition, the annual dollar limit on benefit payments is actuarially reduced for early retirement and actuarially increased for retiring later. Other restrictions imposed by the IRC include a limit on annual contributions to the STRP in excess of the lessor of $30,000 or 25% of salary and various restrictions on the amount of permissive service credit that a member can purchase. The retirement benefits of CalSTRS members who retired during the period from January 1, 1991 through June 30, 1995 were limited to 100% of the member’s average compensation pursuant to the IRC. That limit was later repealed effective with the 1995-1996 plan year.

In 1988, many public plans were required by state constitutional or statutory law to pay the full benefits accrued by their members, even if doing so would cause the plan to lose its qualification. A “grandfather” clause was included in the Technical and Miscellaneous Revenue Act (TAMRA) to permit state and local government plans to avoid disqualification on the payment of

existing benefits. By electing the grandfather clause, CalSTRS was protected from disqualification under the federal limits for those benefits accrued by members who had been hired prior to January 1, 1990, under the plan provisions which were in effect on October 14, 1987. With that grandfather election, the benefits of the plan as of October 14, 1987 and accrued to pre-1990 members were fully protected from the dollar limit restrictions and therefore payment of those benefits would not cause the plan to be disqualified. All benefits of the plan accruing to members hired after December 31, 1989, and all benefits added to the plan since October 14, 1987 are however, subject to the dollar limit restrictions. Failure to adhere to those restrictions could cause the plan to lose qualification. In addition, the actuarial reduction in the dollar limit for early retirement and the actuarial increase in the dollar limit for later retirement were not the same for the two sets of members. Those members hired before January 1, 1990 were subject to more liberal actuarial reductions, providing the full $130,000 dollar limit between ages 62 and 65, while the members hired on or after January 1, 1990 were subject to more restrictive actuarial reductions, providing the full $130,000 dollar limit at either age 65, 66, or 67, depending upon the year in which the member was born.

The grandfather election resulted in three separate applications of the dollar limits:

(1) Members hired before January 1, 1990 are completely exempted from the dollar limits for benefits which accrued under the plan as it existed on October 14, 1987;

(2) Members hired before January 1, 1990 who accrued benefits which were added to the plan after October 14, 1987, such as Golden Handshake service credit, have the additional benefit subject to the dollar limit however, it is the more liberal dollar limit; and

(3) Members hired on or after January 1, 1990 have the entire benefit subject to the more restrictive dollar limit.

In 1996, the Small Business Job Protection Act (SBJPA) provided governmental plans with the opportunity to reduce the impact of many of the restrictions on the benefits of the plan while still maintaining CalSTRS tax qualification.

- Of primary interest is the repeal of the 100% of compensation limit. Not only was the 100% of compensation limit repealed for government plans, but the SBJPA also allows the STRP to restore benefits that would have been payable to members if the benefit had not been limited under that restriction. 20 STRP members had their benefits reduced under the 100% of compensation limit. Restoration of those benefits, which were fully funded under the provisions of the plan, will result in a total of $20,000 in benefits to those members. Once authorized by legislation these restored benefits will be payable from the TRF.

- Another aspect of the SBJPA is the opportunity to revoke the “grandfather” election under TAMRA which, while providing protection for the plan from disqualification for certain plan benefits provided to members of the plan as of December 31, 1989, resulted in a different application of the dollar limits to three different groups of members as noted previously. Revocation of the election, which must occur for CalSTRS by June 30, 2000, will result in a uniform application of the more liberal dollar limits to all members. No retired members have accrued a benefit in excess of the dollar limits at this time and no retired members have had their benefits reduced by the dollar limits.

- A third provision of the SBJPA is the opportunity for a governmental plan, such as the STRP, to establish a replacement benefits program exclusively for the payment of the plan benefits which the Section 415 dollar limits prohibit the STRP from paying. The replacement benefits program allows the STRP to continue as a tax qualified plan while also providing a retired member or beneficiary with the full benefit provided by the STRP. A review of the membership database identified seven members who have accrued benefits that would potentially be restricted under the dollar limit if they were to retire this year. Each of these members has more than 34 years of service credit. None of them have submitted an application to retire at this time.

The replacement benefits program will pay STRP benefits that the Section 415 dollar limits prohibit the STRP from paying from the TRF. To determine the amounts that will need to be paid, the plan will require a “limitation year” as the basis for testing benefits against the dollar limit. The calendar year is the best basis for establishing a limitation year because it coincides with the calendar year basis that the annual limit is determined by the IRC, and therefore provides for the most efficient implementation.

The IRS increases the dollar limits in $5,000 increments based upon increases in the cost of living. Annually, CalSTRS retired members receive a 2% COLA. For both of these reasons, participation in the replacement benefits program will not remain static. The portion of a retired member’s benefit that exceeds the dollar limit will decrease as the dollar limit is increased pursuant to the IRC and increase with the addition of each annual 2% COLA. Therefore, both active member accrued benefits and retired member benefits will be tested against the dollar limit initially when an application is made, annually following the 2% COLA calculation, and each time the IRC raises the dollar limit. Active members who have accrued a benefit that approaches or exceeds the dollar limit will be notified. Retired members who have accrued a benefit that exceeds the dollar limit will have their accrued benefit reduced in compliance with the dollar limit. There have been proposals to increase significantly the dollar limits currently imposed. If such increases are enacted, the number of CalSTRS members accruing benefits in excess of the dollar limit could eventually be reduced to zero.

The IRC specifies that the replacement benefits program must be maintained separately from the Teachers' Retirement Fund (TRF) and financed on a "pay-as-you-go" basis. Under the recommended plan, a member or beneficiary with an accrued benefit that exceeds the dollar limit will receive two monthly payments from the STRP. The benefit that does not exceed the dollar limit will be paid from the TRF, and that portion of the benefit that does exceed the dollar limit will be paid from the replacement benefits program with a separate warrant. The replacement benefits payment will be paid by diverting from monthly employer contributions an amount equal to the replacement benefit, plus, if applicable, any administrative expenses of the replacement benefit program, that would be paid in the next month. Only the funds necessary to cover the expected expenses each month will be deposited with the replacement benefits program. The replacement benefits program will essentially carry a zero balance at the end of each monthly payment cycle. The benefit payment will not, however, result in a net cost to the TRF because CalSTRS has been collecting contributions to the TRF in order to pay the full benefit payable under the benefit formula, without regard to any federal limitation. Consequently, the benefits in excess of the federal dollar limit are held in reserve, and will be drawn down as contributions to the TRF are diverted to make replacement benefits.

The IRS considers payments from the replacement benefits program to be salary rather than retirement benefits. Therefore, those payments are subject to employment taxes, federal and state withholding as well as Medicare for some members. The payments are reportable on a W-2, not the 1099 normally used for retirement benefits. The employer portion of Medicare as well as the W-2 are the responsibility of the employer who last employed the retired member.

Several other public systems have established replacement benefits programs. New York State Teachers Retirement System is seeking a private letter ruling on the provisions of their plan before actually making any replacement benefit payments. That system has several members who have had their benefits reduced under the dollar limits for several years. The Arizona Retirement System established a program in 1997 and currently pays two retired members. CalPERS has established a program and made their first payments in March 1999. The Florida Retirement System has established a program, but currently have no benefits payable. The Texas Teachers' Retirement System program was also established in 1997 and currently pays fifteen retired members. All of these systems fund their replacement benefits payments by capturing employer contributions as they are paid to the system and depositing them to the replacement benefits program, rather than the system's trust, consistent with the manner recommended for CalSTRS.

Initially, the replacement benefits program will be administered manually. The testing of benefits against the limits, funding of the replacement benefit program and disbursement of replacement benefits will all take place outside of START. Eventually, if the population of members subject to the dollar limits becomes substantial, START will be modified to accommodate the processes necessary to administer the replacement benefits program.

The vast majority of the members and beneficiaries of the STRP will not accrue a benefit in excess of the IRC Section 415 limits. However, for those few members and beneficiaries who may exceed the limit, CalSTRS will monitor the benefits as they accrue, contributions as they are reported and service credit as it is purchased to impose the restrictions required for compliance with IRC Section 415 limits, as well as provide for replacement benefit payments where permissible.

Without a replacement benefits program, CalSTRS will be prohibited from paying to a CalSTRS member those benefits that accrue under the provisions of the plan but are in excess of the dollar limit. As the IRS increases the dollar limit due to increases in the cost of living, the benefits would be restored to the amount payable under the CalSTRS benefit formula. However, without the replacement benefits program, CalSTRS could not make retroactive payments to the member of amounts reduced in the past due to the dollar limit. The replacement benefits program is specifically for benefits reduced under the dollar limit.

RECOMMENDATION

- Staff recommends the Board sponsor legislation to restore those benefits that had been restricted to a level below 100% of final compensation.

- Staff recommends the Board sponsor legislation to rescind the grandfather election under TAMRA.

- Staff recommends the Board establish a replacement benefits program to pay the full amount of the benefit provided under CalSTRS statutes when that benefit exceeds the dollar limits established under Section 415.